$50.00 ANNUALLY
40 Letters Per Year

DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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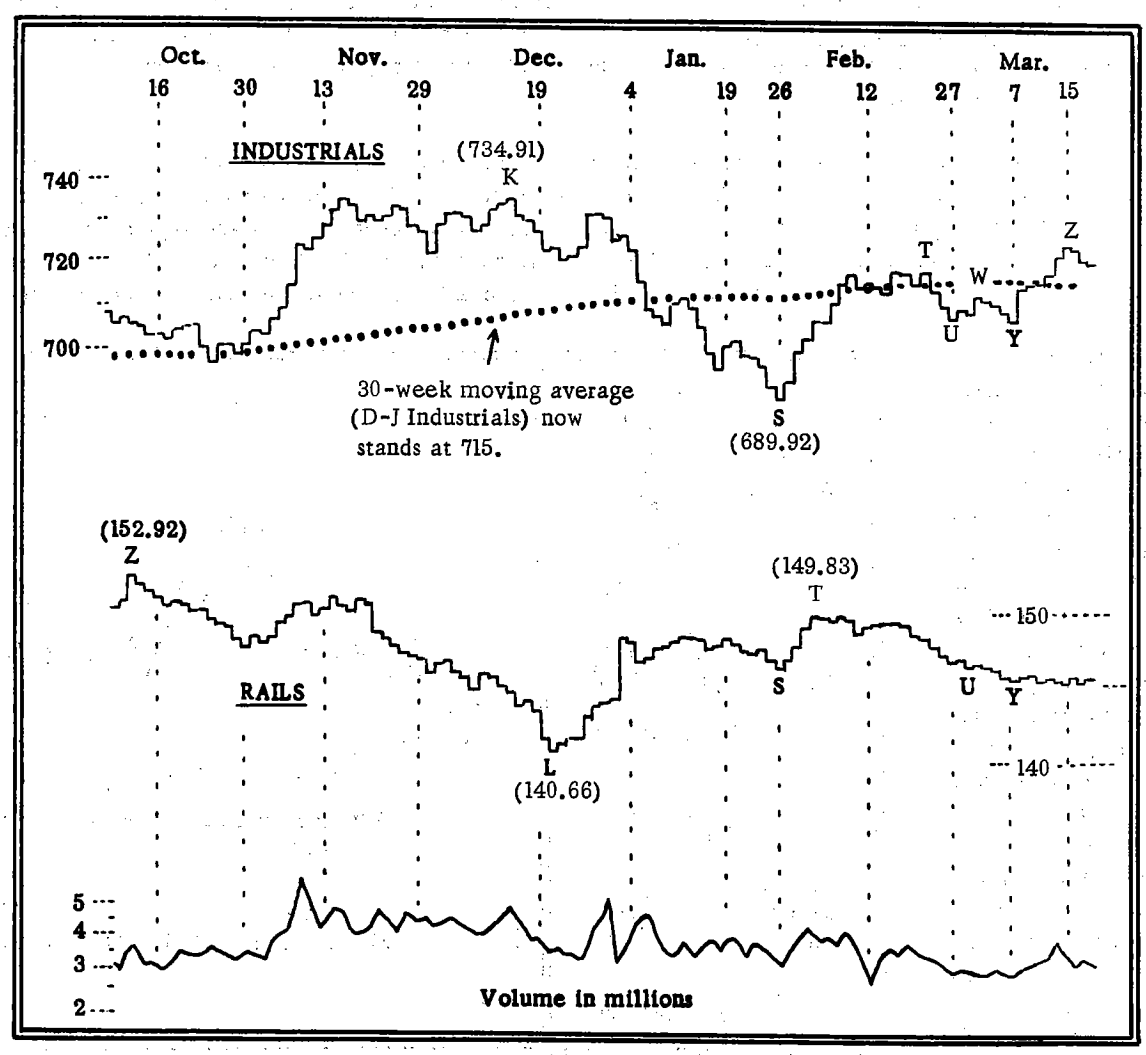
Registered with the Securities and Exchange Commission

March 21, 1962 Number 174 Page 1

THE MARKET The rally which began at Y (see chart) took Industrials to 723.54 (Z); in so doing, it added 17 points to the Industrial Average. The rise, however, was not confirmed by any of the other technical measurements. During the rally, Rails held within the remarkably narrow range of one point! The advance-decline ratio refused to better its February peak (which peak corresponds to point T on Industrials). New highs (which have now been adjusted to the new calander year) showed little tendency to expand. In view of this unsatisfactory action, this writer would not wax poetic over a new (unconfirmed) Industrial high. In fact, if the character of the market was not able to show a substantial improvement over the recent performance, I would take another all-time Industrial high as a technical danger signal (rather than the signal for a broad, extended advance from this area).

Numerous recent Letters have called attention to the unsatisfactory base at Y, together with the general mediocre technical position of the market. Therefore, when "breadth" (the advance-decline ratio) stalled on the Y-Z rise, I took it as a confirmation of the negative undertone of the market.

In view of the foregoing, readers may wonder why I believe that a new Industrial high is such a distinct possibility. Two factors dictate this position: The first is the steady odd-lot selling in the face of the latest rise. The second is the lack of selling pressure (downside volume) on all declines. Sooner or later, this market must resolve itself one way of the other (at least in a secondary sense). For many months buying power and selling pressure have both been notably absent from the market. Declines since December, 1961, were brought on by a lack of buying (not by active selling). Rallies since that time have been largely a result of a drying up of selling (not active buying).



In order to get a sizable swing, we must have either broad buying power or broad selling pressure. In the present situation, one of two things might bring in selling pressure (and a decline sufficient to give us a truly "sold-out" market): (1) Unexpected bad news could set off such a decline.

(2) A technical "failure" could bring about a decline. If the Industrial Average were to push to historic highs, falter, then turn down, I believe that this failure could touch off a large amount of selling pressure. It is well to remember that important investment money (the kind that makes trends) is prone to sell in a rising market. This is the reason that so many major declines have started from excited rally peaks (rather than from dull, sideways areas). Important selling is therefore much more apt to develop at the top of an Industrial rally to new highs than it is from levels such as U and Y.

CONCLUSION: The primary trend is bullish; the secondary trend, now obscure, will be considered bullish if Rails can better T (149.83). It is my opinion that the next important decline will start from a new high on the Industrial Average, rather than from this area (after all, we have been in the 685-735 area for almost a year, and important selling has yet to develop). Again I urge readers to review the section on the "broadening formation" in Letter 172.

TO MAKE MONEY A subscriber (and veteran market analyst) recently visited this office. In the course of our conversation, he asked: "Mr. Russell, if you were limited to just a few market statistics and charged with managing a portfolio, what statistic would you choose?" I immediately answered that I would insist on the daily closing of the D-J Industrials and Rails and daily volume. "I agree," said the visitor, "and suppose I were to give y ou one additional statistic, what would your choice be?" After a pause I answered: "the advance-decline ratio". The gentleman heartily agreed with my second choice.

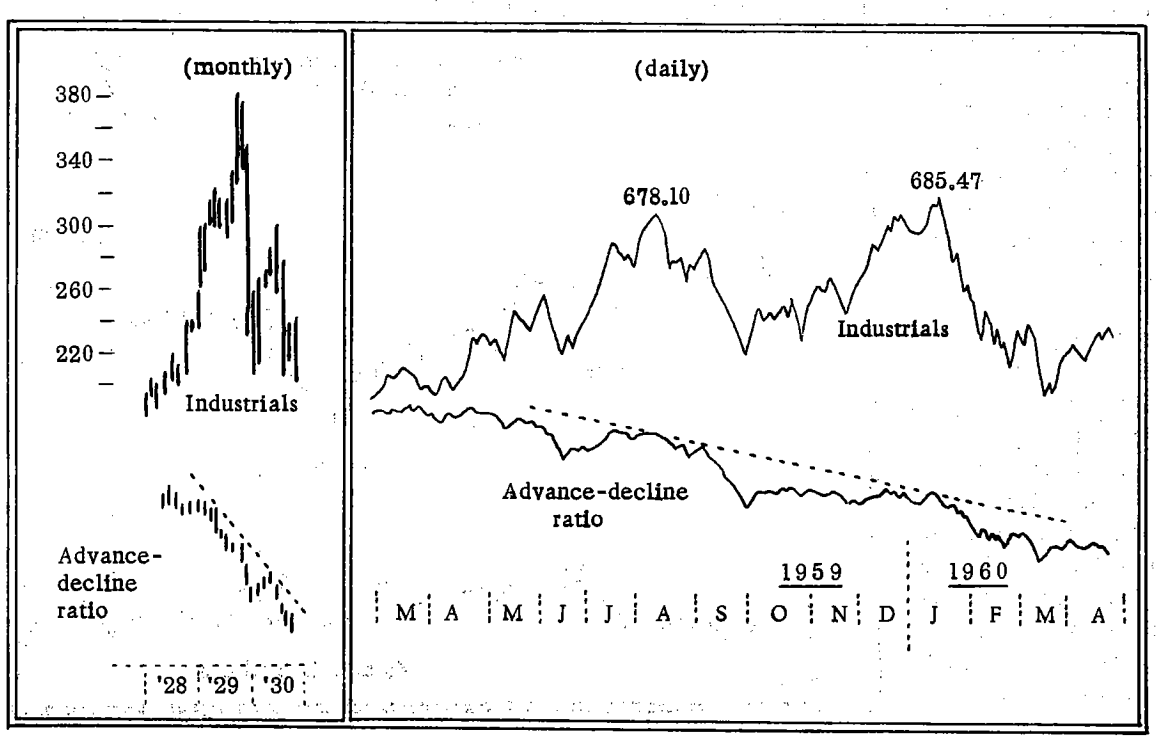
The Averages are a classic barometer for measuring the thinking of "investment money" (i.e., the type of money that deals in high-grade stocks). The advance-decline ratio (A-D ratio) is a gauge of everybody's thinking (the A-D ratio portrays the advancing or declining tendencies of all the stocks traded on the New York Stock Exchange). From careful studies of the Averages and the A-D ratio, one can deduce a great deal concerning the technical position and general trend of the market.

Unfortunately, the daily and even the weekly records of the A-D ratio are, for the most part, unavailable. They have been lost in the murky past of stock market history (although a handful of people do boast possession of such records).

This ignorance concerning the history of the A-D ratio has resulted in a great many unfortunate misconceptions. For instance, most people still do not understand that in order to make money with a diversified list of stocks, they must have the broad impetus of a bull movement behind them. In a viciously selective movement (during which the Industrial Average may advance alone), it becomes a near impossibility to come out ahead (particularly when one considers the "bid and asked" differential, taxes and commissions).

Many subscribers remember the situation in 1959, when, in the face of a steadily declining A-D ratio, the Industrial Average surged to successive all-time highs. That complex performance is illustrated on the accompanying chart, and it would be safe to say that following the March, 1959 peak on the A-D ratio, few stockholders showed anything but losses for their efforts (despite the August all-time Industrial high of 678.10 and the January, 1960 high of 685.47). The fact was that the majority of stocks were in a declining trend throughout 1959, and the Industrial surges were simply dangerous technical "cover-ups".

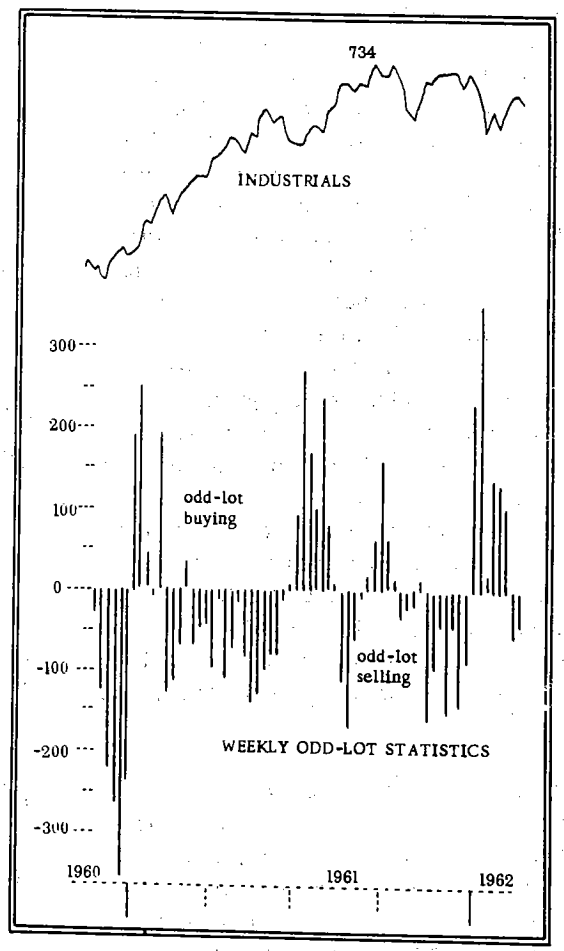
To present another example, perhaps one in a hundred market students are aware of the situation which existed in the famed year 1929. The accompanying chart shows that the A-D ratio was actually sinking at an alarming rate during that year (it recorded its high in mid-1928!) but despite this, the Industrial Average put on an incredible performance, rallying from a February low of 295 to a September high of 381. Thus when the



"crash" came in October, the majority of stocks were on their way down anyway, and the added force of a collapsing Industrial Average simply increased the impact of what had (up to then) been a persistent "slide".

Since 1919 there have been five separate periods during which the market was rendered technically vulnerable by the following sequence: (1) The A-D ratio and the Industrial Average rose to highs together. (2) Both indicators declined. (3) Industrials then rallied and recorded new highs five or more months after the peak established by the A-D ratio. In each case, this unusual time lag between the peak on the A-D ratio and the later peak on Industrials had the effect of "throwing the wheels of the market out of kilter". Regardless of the strength of the subsequent Industrial recovery, it can be stated that: (1) The first peak on the A-D ratio stood as the height of market breadth. (2) Following a series of one or more Industrial recovery highs, the market went into a severe decline (and the greater the solo Industrial recovery, the greater the decline).

To bring matters to the present, the A-D ratio recorded its high in May, 1961. That peak was followed seven months later by an all-time high on the Industrial Average (734.91). As of this writing, we are again within 10-15 points of a new recovery high on Industrials, but the A-D ratio is still far below its 1961 peak.



CONCLUSION: Because of the 7 month lag between the 1961 high on the A-D ratio and the subsequent December high on the Industrial Average, the odds do not favor the 1961 high of the A-D ratio's being surpassed. In effect, this places a "ceiling" on the A-D ratio (despite a good chance of new highs on the Industrial Average). A solo Industrial rise, unaccompanied by broad market breadth, however, has always meant frustration and difficulties for traders and investors. For this reason, I would treat any rise from this area with utmost caution.

SOMETHING NEW In Letter 169 I listed eight phenomena which have occurred since 1949, each of them unprecedented in the annals of stock market history. Re-reading this list, one is made increasingly aware of the fact that the current market is not responding to time-tested historic relationships.

Two more observation are now worth bringing to the attention of subscribers. Many analysts are convinced that the present market is a continuation of a primary bull trend which began on June 13, 1949. If this is true, then for the first time in history we are witnessing a bull market third phase that has lasted longer than either of the two preceding phases. Historically, the first and third phases of a bull market are the shortest (in time), while Hamilton and Rhea pointed out on numerous occasions that the second phase is invariably the longest. Yet the second phase of the bull market lasted from 1953 to 1957 or 33 months. If we take the position that we are now in a third phase which began in October, 1957, then the third phase of this bull market has lasted (so far) 52 months! Speculation, crowd participation and overvaluation (all third phase characteristics) have never been so sustained in the history of the stock market.

A second curious situation concerns odd-lot (under-100-share) trading. The odd lotters (whose activity is generally considered to reflect public sentiment) switched from buying to selling in November, 1960 (see chart). Sixteen months have elapsed since then, but with the exception of four brief buying areas (two of which were the normal January reinvestment periods), odd-lot selling has continued with remarkable persistency. The period since late 1960 represents the longest period of odd-lot selling ever to appear within a bull market's third phase; it is also one of the longest periods of odd-lot selling on record. The odd-lot statistics have probably contributed more to keeping Wall Street's analysts bullish than any other single technical factor, yet the sluggish market of the last year has not responded as it has in the past.

STOCKS Thirty-four of our fifty-six "key" stocks are now above their ten-week moving average, an improvement of eight from last week (and the best showing in some time).

Nevertheless, in studying the charts and technical position of hundred of stocks, I find it increasingly difficult to come up with intelligent suggestions. Groups showing outstanding strength are drugs, textiles, glass and paper. This should help such recent recommendations as Merck, National Distillers, Chadbourn Gotham and Celanese.

Baldwin Lima was recommended in Letter 171 for purchase in the 15 1/2- 16 1/2 area. The stock did dip to the top of that area, then rose sharply. It met resistance just under its 1961 high of 19 1/8. Just how important the 19-20 area on Baldwin is can be seen on the weekly chart. This is the fourth approach to the 19 area since 1959, and B has now formed a potential giant inverse "head-and-shoulders" pattern. Such structures (when bettered) can launch important upward moves. For subscribers who did not buy B at the 16 1/2 area, I would now suggest waiting for a move above 19 1/4 before making purchases. I feel that if the stock can better all highs since 1959 (above dotted line on chart), the market will be saying that something new and perhaps quite dynamic is happening to this company. Another plus in Baldwin is the fact that it does not have a large following and is not being "written up" by the analysts (Baldwin in a component of Barron's Low-Priced Stock Index).

International Paper is the leading equity in a strong group. The weekly chart shows IP moving against the 38 level, a level which forms the top of an ascending triangle. The stocks seems to me to be one of the better vehicles for participation in an upward move from this area (even if such an upward move were largely confined to the stocks in the D-J Industrial Average).

Charts courtesy of Trader Research, P. O. Box 2644, St. Louis 16, Mo.

Written Wednesday, March 21, at 10 A.M.